GDS Global Limited

Responses to SIAS' questions on GDS's Annual Report FY2016

Q1. The company made its maiden acquisition as a listed company in January 2016 by acquiring a 51% majority stake in a complementary business, Grimm Industries Pte. Ltd. ("Grimm") for an aggregate purchase consideration of $2,040,000. In the announcement dated 29 January 2016, the rationale for the acquisition was stated as:

> *The Acquisition is a strategic investment by the Group and will allow the Group to strengthen its competitive advantage and its positioning as a leading specialist provider of commercial and industrial door and shutter solutions. It would enable the Group to leverage on the strength of the Target's expertise and network to design and procure proprietary components to be used in the manufacturing of its commercial and industrial door and shutter systems. This may lead to synergies that will result in better quality of proprietary components and increased cost savings.*

The goodwill on acquisition was recorded as $859,531 (page 82 of the annual report – Acquisition of subsidiary) and intangible assets (consisting of customer relationships and order backlog) amounted to $824,087.

In the Chairman's message to shareholders (page 4), it was said that "the integration of Grimm into the Group and the resultant synergies have been very encouraging."

a) Can the company provide shareholders with more details on the stage of the integration of Grimm into the group? When would the integration be completed?

b) Can the company quantify some of the resultant synergies? For example, has the acquisition of Grimm led to increased sales in the group's core business of door and shutter systems? What is the expected cost savings after the integration of Grimm?

c) Since the acquisition of Grimm in January 2016, has the newly acquired subsidiary performed up to expectations? What are the lessons learnt by management from the acquisition and the subsequent integration over the past twelve months?

d) Would the group be looking to make more acquisitions in the near future?

Response

Our strategic stake in Grimm has strengthened the Group's supply chain management by enabling us to leverage Grimm's network of suppliers to procure and customise proprietary components to be used in the manufacturing of our commercial and industrial door and shutter solutions. This not only results in higher cost and time savings for us but also allows better protection of our intellectual properties.

Grimm contributed around S$3.35 million to our revenue in FY2016. In general, revenue and net profit generated from Grimm have been in line with our internal projections thus far.

Our priority is to grow our core business. With this in mind, we will keep our options open on potential acquisitions if and when a suitable opportunity arises.

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Q2. From the Financial Highlights (page 8), it can be seen that revenue increased to $25.1 million and the gross profit margin has been stable at 45.4%. However, net profit margin dropped to a low 10.9% as other operating expenses increased from $289k to $883k mainly due to the increase in allowances for impairment of $400k to $550,423.
Receivables that were individually assessed for impairment included (page 77 – Trade and other receivables):
- Customers placed under liquidation ($172,563)
- Customer under litigation ($457,068)
- Past due more than 12 months and no response to repayment demands ($196,885)

Also, in note 3 (page 69 - Key sources of estimation uncertainty), it was disclosed that the group has experienced certain challenges with collection of a further $568,000 which is outstanding from certain customers as at year end which has not been provided for.

a) Given that trade and receivables have increased to $9.5 million and that there are signs of deteriorating credit worthiness of the customers, is the current credit risk management policy sufficient as the group grows and expands to new markets and to new clients?

b) Can the company identify the profiles of the customers that are having difficulties in paying or have defaulted?

c) Is there a need for the board and the company to review and update its credit risk policy?

d) Was this policy strictly enforced, especially with first time clients or clients in the Middle East?

Response

The provision in our trade receivables was made in prudence and in view of uncertain market conditions. As part of our policy to mitigate credit risks, the Group requires higher, or in some cases full, advance payment before signing new contracts with customers. We strictly enforce this requirement especially with first time clients or clients whom we deem have a higher credit risk. We also closely track and monitor debtors risk profile and take actions to mitigate our risk where necessary. In view the above, we believe our credit risk management policy is adequate. We also review our credit risk policy regularly and are prepared to update it should the need arise. However, as we are related to the construction industry, we are constrained by the Security of Payments Act 2004 with regard to payment claim procedures and timelines.

Q3. In the Chairman's message to shareholders (page 7), it was disclosed that a customised production automation line that employs robotic welding and heavy material handling equipment will be operational by mid-2017.

a) What is the current utilisation rate of the plant (before this new $1.5 million capital investment)?

b) What is the expected increase in the production capacity after the capital investment?

c) With the new customised production automation line, what are the projected benefits on:
i. Quality,
ii. Range and complexity of products,
iii. Cost base of the products?

<u>Response</u>

As previously disclosed in the Company's Offer Document dated 11 April 2013, it would not be meaningful to measure the utilisation rate of our manufacturing facilities as we do not manufacture standardised items. Our services vary for each project in terms of customers' specifications, complexity, resource requirements and time required.

The introduction of the customised production automation line is however expected to increase our productivity and improve process efficiency.

The expected benefits of our new customised production automation line would include:

- Better quality control and higher productivity – The quality of our products is expected to be higher and more consistent and with a lower defect rate, thus requiring less rectification work.

- Increase in volume of higher-value products – As a higher quantity of door and shutter solutions can be produced in shorter amount of time, we anticipate a change in our sales mix toward these higher-value products. We expect to improve our market share in the fire-rated shutter and insulated panels in the region with this change of sales mix.

- Labour cost savings – Given rising labour costs and difficulty in employing locals, the Group expects to reap significant savings on labour costs with the production automation line.
